

Company Update — February 25, 2021

Water Utilities

Essential Utilities, Inc. (WTRG)

WTRG: Recent Weakness Provides Attractive Entry Point – We Remain Bullish on WTRG's LT Growth Prospects

Our Call

We believe the recent weakness provides an attractive entry point as the fundamental narrative has not changed. Since 1/8, shares of WTRG are down 11%. This trails “larger cap” water utility peers (-0% to -8%), gas LDCs (+6%) & S&P Utilities (-5%). We reiterate our Overweight rating and \$52/sh price target (29X our 22E). WTRG's YE'20 update was consistent with the mid-January guidance event including '21 diluted EPS guidance of \$1.64-1.69 (cold YTD weather has Peoples off to a strong start), a 5-7% EPS CAGR target through '23 and \$3B of capex over the 2021-23 period which will drive underlying 6-7% water and 8-10% gas rate base CAGRs. Our 21-25E EPS remain \$1.67, \$1.80, \$1.93, \$2.07 & \$2.20. Our forecast results in an EPS CAGR near the upper end of WTRG's 5-7% range which we believe is reasonable given strong underlying rate base growth driven by accelerated pipeline replacement needs and a municipal M&A strategy that continues to gain momentum.

A Very Healthy Municipal Deal Pipeline. Following a solid 2020 (\$63M of deals), 2021 is shaping up to be even better (signed \$90M of new deals in 2020). Besides the \$277M DELCORA deal, WTRG has five other signed APA's which will add \$161M in rate base – includes four separate chunky wastewater deals (East Whiteland, PA \$55M; Lower Makefield, PA \$53M; Bourbonnais, IL \$32M; Williston Township, PA \$17.5M). In addition there is the \$12M purchase of Shenandoah, PA's water assets – the borough council approved the deal in late November and the APA is still being finalized. WTRG's deal development pipeline remains robust and management continues to express optimism that activity will start ramping up in the years ahead in the four states that only somewhat recently adopted FMV legislation (NC & OH in '18; TX in '19; VA in '20). Our model reflects primarily announced deal closures over the 2020-22 period plus a \$75M/year placeholder in '23 & beyond. This could prove conservative if the recent pace continues.

Big Picture DELCORA Thoughts. We believe the deal will close as discussed in greater detail later in this note. Getting DELCORA across the finish line is more important than the timing of it given the longer-term strategic value it represents. Beyond the \$277M rate base pick up at closure (expected early Q2'21), we are attracted to (1) the \$700M of capital investments – \$25-50M/year for typical repair/replace work plus roughly \$300M over the 2026-28 period related to DELCORA's treatment plant – as well as (2) the likely substantial wastewater tuck-in deals that could transpire in the area. But our Overweight thesis is not solely predicated on DELCORA closing. We believe relatively low risk, regulated EPS growth in the 5-7% range is achievable without driven by pipeline replacement needs and municipal M&A momentum. That rate of growth would simply be enhanced if DELCORA closes as it should allow WTRG to extend it through the end of the decade and perhaps even raise it.

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Rating	Overweight
Ticker	WTRG
Price Target/Prior:	\$52.00/NC
Upside/(Downside) to Target	19.6%
Price (02/25/2021)	\$43.49
52 Week Range	\$30.40 - 52.00
Shares Outstanding	245,271,727
Market Cap (MM)	\$10,667
Enterprise Value (MM)	\$16,023
Average Daily Volume	979,436
Average Daily Value (MM)	\$43
Dividend (NTM)	\$1.00
Dividend Yield	2.3%
Net Debt (MM) - last reported	\$5,357
ROIC - Current year est.	9%
3 Yr EPS CAGR from current year (unless otherwise noted)	7%

\$	2020A	2021E	2021E	2022E	2022E
EPS		Curr.	Prior	Curr.	Prior
Q1 (Mar)	0.60 A	0.67 E	NC	-	NC
Q2 (Jun)	0.29 A	0.25 E	NC	-	NC
Q3 (Sep)	0.23 A	0.25 E	NC	-	NC
Q4 (Dec)	0.46 A	0.50 E	NC	-	NC
FY	1.58 A	1.67 E	NC	1.80 E	NC
P/E	27.6x	26.1x		24.1x	

ROIC - Current year est.; ROIC is actually ROE Source: Company Data, Wells Fargo Securities estimates, and Refinitiv.
NA = Not Available, Volatility = Historical trading volatility

Next PA Rate Cases

WTRG does not have any major rate-setting procedures pending. The next PA water & wastewater rate case filing is expected around mid-'21 while the next gas one might be made in late '22. While WTRG's PA rate cases can never be overlooked given the meaningful % of rate base represented (more than 70% on the water/wastewater side), the utility has a long history of reaching constructive outcomes via settlement agreements. In addition, despite the pandemic-related economic challenges faced by many ratepayers that has led to heightened rate sensitivity in some states, the PA regulatory environment has upheld its constructive reputation – includes the recent NI rate case outcome as well as the ALJ recommendation in the pending AWK case which honors the 10/30 settlement agreement.

Peoples Repairs Tax Deduction Settlement

Management noted that a verbal settlement has been reached with intervenors that will give back 100% of the catchup benefits to ratepayers over a 5-year period. This contrasts with WTRG's proposal where 40% of the benefits would have been shared directly with ratepayers through surcredits on bills and the remaining 60% used as an increasing income tax expense offset over the 2023-25 period in order to avoid implementing a gas base rate increase prior to 1/1/2026. We view the move as goodwill gesture on WTRG's part to help provide customers with some additional bill relief as they deal with the economic impacts of the pandemic. As noted above, we expect Peoples next base rate filing could occur in late '22.

A Deeper Dive Into The DELCORA Approval Process

Since the ALJ recommendation for denial of the \$277M deal was posted to the PaPUC website on 1/12, a few developments have occurred.

(1) **Delaware County on 1/21 appealed the 12/28 decision** by Judge Barry Dozor in the Court of Common Pleas of Delaware County. Recall, Judge Dozor ruled against Delaware County's two claims and in favor of DELCORA and WTRG regarding the validity of the asset purchase agreement as well as the ability to put the net proceeds of roughly \$200M from the sale into a trust to be used to stabilize ratepayers' bills in the years ahead.

(2) **Settlements have been reached with two more of the municipalities** that had not yet consented to the transfer of the assets and/or assignment of contracts to WTRG from DELCORA and each has discontinued its Complaint in the Court of Common Pleas of Delaware County. One was SWDCMA which constitutes ~5% of DELCORA's annual revenues or the bulk of the 9% represented by all of the holdouts. That leaves only two remaining (the Townships of Edgmont and Lower Chichester) out of the 49 total municipalities served. Discussions remain ongoing and the parties do not oppose the PaPUC approving the DELCORA transaction with the condition that these contractual issues be resolved prior to closing.

(3) **WTRG and DELCORA withdrew the proposed customer assistance bill payment that the ALJ recommendation concluded was a "rate stabilization" plan.** Rather than show it as a credit against the amount due on wastewater bills, DELCORA customers will get the \$200M of net benefits from the transaction through direct mail, quarterly payments.

We continue to believe the DELCORA deal will eventually be approved by the PaPUC and close. For starters, the ALJ recommendation does not necessarily convey the PaPUC commissioners' views. That point was highlighted just recently in the constructive conclusion of NI's rate case despite an ALJ recommendation to deny the requested increase altogether. Approval just may take some additional time beyond WTRG's early Q2'21 target. We cannot rule out the potential need to re-file the PaPUC application and/or extend the current statutory timeframe beyond the 3/26 deadline. With only four of the five PaPUC commissioner chairs filled right now, it is possible a 2-2 stalemate occurs.

But under the assumption the ALJ recommendation is consistent with where commissioner heads were in mid-January, WTRG has largely addressed the concerns expressed, in our opinion. Recall, ALJ rationale for denial was that (1) ongoing litigation regarding DELCORA's ability to transfer assets under the asset purchase agreement and (2) WTRG's failure to attach the rate stabilization plan to the application make it too difficult to make an informed recommendation regarding if the deal is in the public interest.

We believe the 12/28 Court of Common Pleas order combined with the additional municipal settlements (and likely two future ones) should allow the reasonableness of the purchase price under

PA's FMV law as well as the public interest determination to be made by the PaPUC. Reaching a settlement with Delaware County – an outcome that management continues to strive for, possibly even after the 3/26 PaPUC decision deadline – that results in dismissal of the appeal would seemingly de-risk the conclusion even further. Finally, the withdrawal of the “rate stabilization” plan should make the ALJ's concern on that point moot.

Acronyms Used:

ALJ – Administrative Law Judge

APA – Asset Purchase Agreement

DELCORA – Delaware Country Regional Water Quality Control Authority

FMV – Fair Market Value

PaPUC – Pennsylvania Public Utility Commission

Price Target Basis and Risk

Price Target for WTRG: \$52.00 from NC

Our \$52/share price target reflects both a P/E multiple and DDM analysis. In terms of P/E, we apply a 70% water/30% gas utility hybrid multiple to our 2022E of \$1.80. For WTRG's water utility multiple, we ascribe a roughly 5% discount to the 21E multiple we use for AWK (34X, which is a 5-10% premium to the pure play water peer group median). We consider AWK to be WTRG's closest peer on the water side based on scale, key states/regions and municipal consolidation strategies. The roughly 5% discount reflects a modestly lower earnings growth rate (we forecast roughly 7% for WTRG's water business vs. 8% for AWK) as well as lower ESG appeal (primarily due to the Peoples gas utility). For WTRG's gas utility multiple, we utilize the 21E pure play gas LDC median of 18.0-18.5X (based on ATO, NWN, OGS & SR) and then apply a roughly 10% premium to it. We believe a premium is warranted as (1) Peoples is at the early stages of a multi-year accelerated pipeline replacement effort which is expected to drive healthy rate base growth for the foreseeable future (WTRG's 3-year guidance is 8-10%), (2) we believe Western PA, which sits above the prolific Marcellus and Utica shale plays, is largely immune to the anti-gas sentiment impacting some areas of the country and (3) most of Peoples falls under the constructive PA regulatory framework.

Risk for WTRG

Key downside risks include adverse regulatory decisions, issues with the Peoples gas deal integration and earnings accretion, missteps with regards to the M&A strategy and execution as well as potential anti-gas sentiment and ESG concerns stemming from the ownership of a gas utility.

Investment Thesis

WTRG

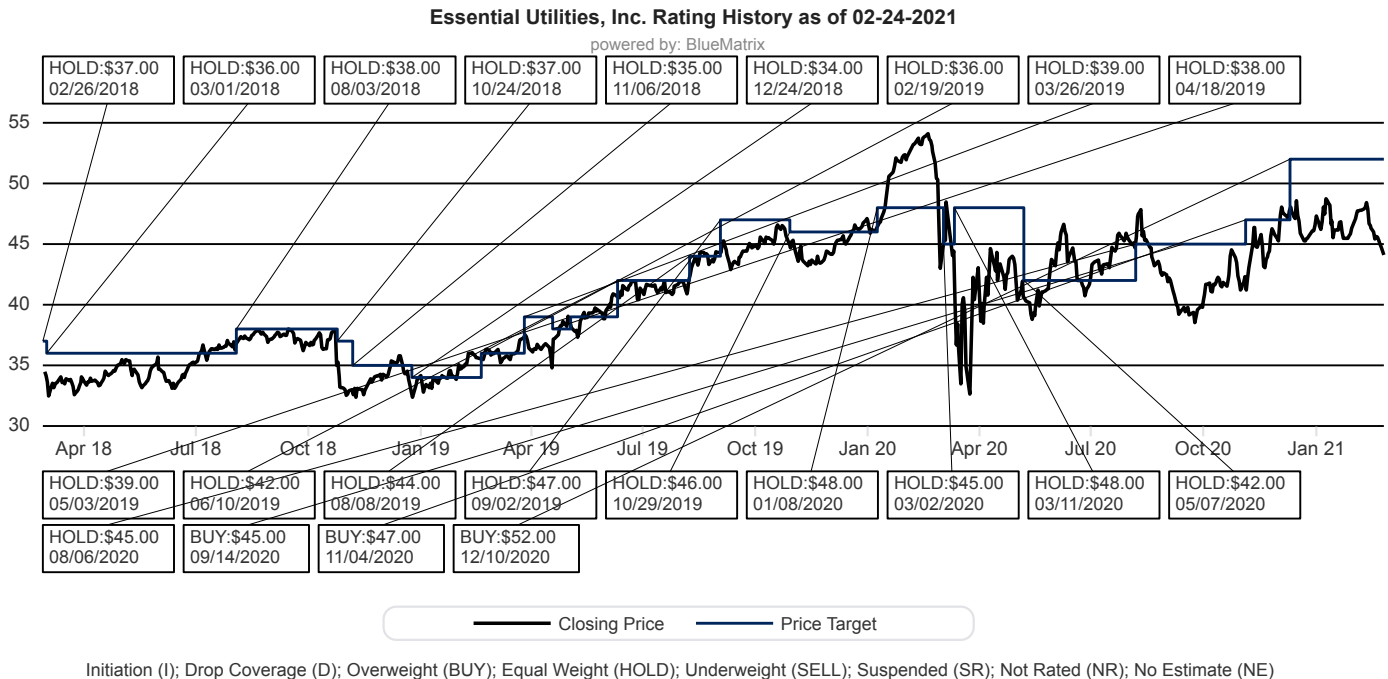
Our Overweight rating is premised on our belief that WTRG shares do not fully reflect the company's strong fundamentals which include a proven EPS growth strategy, a rate base that is growing at a mid-to-upper single digit CAGR, constructive regulatory treatment (particularly in PA where roughly 70% of earnings are derived and near-term regulatory risk is relatively low as both the water and gas utilities completed rate cases in 2019), an efficient operating model and a solid financial profile. We believe relatively low risk, regulated EPS growth of at least 6% is achievable driven by the timely rate recognition of elevated pipeline infrastructure investment needs for the foreseeable future supplemented by water/wastewater municipal M&A trends.

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WTRG:

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